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C O N F I D E N T I A L SECTION 01 OF 04 HARARE 001775

SIPDIS

STATE FOR AF/S, AF/EX, HR/OE-MTRACY
NSC FOR SENIOR AFRICA DIRECTOR JFRAZER
USDOC FOR 2037 DIEMOND
LONDON FOR CGURNEY
PARIS FOR NEARY
NAIROBI FOR PFLAUMER
PASS USTR - ROSA WHITAKER
TREASURY FOR ED BARBER AND C WILKINSON

E.O. 12958: DECL: 08/04/2012
TAGS: ECON EFIN ETRD ZI
SUBJECT: STEALTH DEVALUATION: "THROUGH THE BACKDOOR"

REF: HARARE 01728

Classified By: Labor Officer KRBel for reasons 1.5 (B) and (D).

¶1. (C) Summary. Despite President Mugabe's vigorous insistence that "devaluation is dead" (see reftel), the GOZ has tacitly conceded -- within a matter of days -- that devaluation is in fact very much alive. On July 25, Finance Minister Simba Makoni (who was obliquely castigated by Mugabe in the same speech as a "saboteur" and "enemy of the government" for advocating devaluation of the Zim dollar, see reftel) announced new pricing structures for both tobacco and duty calculated on imported luxury goods. While the official exchange rate continues to be pegged to the US dollar at 55:1, the newly-announced "viability price" for tobacco mandates payment to tobacco growers of Zim $317 per kilo of tobacco, which is a de facto devaluation to 158.5:1. Additionally, for customs/duty purposes, the valuation of luxury import goods will be calculated at 300:1. These new calculations join the existing exchange differentials which benefit gold producers, exporters, and the tourism industry, among others. In actuality, all imports -- with the exception of fuel and energy -- are the beneficiaries of targeted devaluation. While he is adamantly refusing to devalue the Zim dollar across the board, Mugabe has allowed the creation of a patchwork monetary policy where the exception is rapidly becoming the rule. End summary.

Gold

¶2. (U) Gold mining was one of the first sectors to benefit from a differential price structure. By law, all Zimbabwean gold must be sold to the Reserve Bank of Zimbabwe (RBZ), which sells the gold to the world market based on US dollar prices. Initially, the RBZ paid the producers in Zim dollars, until the rising discrepancy beginning in mid-2000 between the official exchange rate and the parallel market rate rendered this unworkable. Gold producers complained about their inability to import necessary equipment, such as machinery, spare parts, and explosives, based on profitability calculated at the official exchange rate. In response, the GOZ initiated the "support price structure" for the industry, which pays the producers on an 80/20 split. Eighty percent of the purchase price is paid out in Zim dollars based on a premium determined by the RBS (e.g., the US dollar price for gold), which works out to approximately 126:1. The other 20% is paid out in forex, resulting in a "blend rate" of about 170:1.

Exports

¶3. (U) Industries which produce for export, and therefore generate forex, were the next beneficiaries of differential price structures. Exporters are allowed to maintain Foreign Currency Accounts (FCAs), which pay out 40% of an exporter's income at the official 55:1 rate, but allow the exporters to retain 60% of their income in forex -- provided that they spend that forex within the next sixty days. This ostensibly provides a pool of forex for export companies to fund their necessary inputs, capital improvements, equipment costs, and other capital expenses which require forex payments. If a company does not spend its forex within sixty days, the remaining funds are subject to "forced conversion" and the exporter receives the equivalent in Zim dollars changed at the official 55:1 rate. In essence, for the first 40% of an exporter's earnings as well as any of the 60% of forex funds not turned around within the mandated time, at the current parallel rate of 690:1, the RBZ -- and thus the GOZ -- keeps Zim $635 for each US $1 earned.

Non-Governmental Organizations / Embassies

¶4. (U) Non-governmental organizations (NGOs) and foreign embassies are also beneficiaries of special treatment. NGOs

and foreign embassies are allowed to bring in forex which is not subject to forced conversion IF they are 100 percent funded from outside Zimbabwe. If the NGOs, particularly, are partly funded from local sources, they are subject to the same regulations, including the 60/40 split, described above for exporters.

Export Processing Zone Enterprises

¶5. (U) Export processing zone (EPZ) enterprises, which are specially-designated companies that export at least 80% of their product, are able to retain 100% of any forex they earn without the sixty-day time limit. This category almost exclusively comprises new companies which have existing markets in foreign countries; of the one hundred or so companies which qualified for this status, very few were existing companies which earned reclassification. Essentially, these companies are able to retain their forex until they want to use it.

Zimbabweans / Foreigners with Outside Resources
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¶6. (C) Zimbabweans who legitimately have access to outside sources of forex, such as those with relatives working in Britain, are not yet subject to any forced conversion to Zim dollars (although such has been advocated in some circles, see reftel). Additionally, foreign investors with capital -- e.g., those investing in money markets -- are free to keep their forex or exchange it on the parallel market, for the moment. If parallel market sources such as bureaux de change are shut down or become more heavily regulated, this will limit to some degree the freedom of these individuals to benefit from the true value of their resources, although predictably we would expect a black market to emerge and handle much of this volume.

Tourism

¶7. (U) Tourist operators have long had a multi-tier pricing structure, which (while not technically a devaluation) certainly qualifies as a differential price structure. The first three tiers separate prices according to whether visitors are international, regional, or domestic. In contrast to international visitors, who must pay a higher rate -- in forex hard currency or via forex-based credit cards -- Zimbabwean residents pay a nominal rate in Zim dollars. For instance, the official price for a double room at the Miekles hotel in Harare is US $ 140 in hard cash for an international visitor (which translates to Zim $ 96,600 at the parallel rate), while a Zimbabwean resident pays Zim $17,000 (or US $24.64 at the parallel rate). Similar pricing structures pertain at other local establishments, including Victoria Falls and various game reserves.

¶8. (C) Further, there is a fourth tier, unofficially termed the "Tourism Exchange Rate," which qualifies as outright devaluation. This is the rate at which tour operators who get paid in international funds remit payments to hotel operators who are paid in Zim dollars. This rate, while not officially sanctioned by the GOZ, has been in operation for approximately the past ten months. To determine the Tourism Exchange Rate, a prominent local economist contacts four parallel market forex dealers and ascertains the rate of the last deal of each, averages those four rates, and calculates 60% of the average. The tour operators then use this rate to remit payments to the hotel operators. This economist has been determining the Tourism Exchange Rate on a weekly basis for application to transactions completed during the following week, with the most recent value computed at 438:1.

Tobacco

¶9. (U) At the beginning of the current tobacco sales season the GOZ announced that although buyers would be paying in US dollars, the growers would be paid in Zim dollars to avoid the type of forex-based speculation which reigned last year and provided a windfall for buyers. This resulted in several days of protest at the tobacco auction houses, during which many growers refused to consummate sales wherein they received inadequate payment in Zim dollars despite reasonable prices offered in US dollars. Makoni subsequently announced an 80% "price support" for tobacco growers, which resulted in the farmers being paid at the "blend rate" of Zim $99 per kilo. Since the buyers paid for their purchases in US dollars, this meant that the GOZ retained anywhere from Zim $777.30 per kilo (for tobacco selling at a low of US $1.27 per kilo) to Zim $1957.20 per kilo (for tobacco selling at a high of US $2.98 per kilo). After the announcement of the new "viability price," the farmers are being paid at an exchange rate of 158.5:1, with retroactive effect for all sales made this season. Using an average price of US $2.00 per kilo, GOZ has now agreed to pay the growers Zim $317.00 per kilo. The interesting point here, of course, is that the GOZ still

retains the difference between the growers' payout and the buyers' remittance in forex.

¶10. (U) It remains unclear whether this support price will provide enough incentive to save Zimbabwe's tobacco market, which has traditionally depended on the output of large-scale commercial growers. The general estimate is that it costs between Zim $200-$300 to produce one kilo of flue-cured tobacco. While the more efficient farmers, a category which tends to include the larger scale growers, will undoubtedly make a profit, the profit margin is minimal compared to that they would have made had the government not retained the difference resulting from the imbalanced exchange rate. At this point, based on both the low profitability of this year's crop and the uncertainty as to whether any large-scale growers will be allowed to stay on their land past the August 10th deadline, most estimates of next year's crop point to a 50% reduction from this year's crop -- which itself is about a 25% reduction the previous year's crop. There are already some intimations that the big buyers are looking farther afield for next year's buying season. If the tobacco crop fails to bring the buyers next year, as happened after the Unilateral Declaration of Independence days, it will take a minimum of ten years for the industry to woo them back, when and if it recovers a sound footing.

Luxury Goods

¶11. (U) The last category of products subject to a devaluation is "luxury goods," which is defined as any import which does not "feed into production and essential services." This group of non-essential goods includes passenger vehicles, oil fats, beverages, tobacco and manufactured goods. Since the luxury products are now valued at an exchange rate of 300:1 rather than 55:1, the duty on these goods can potentially rise in the range of 500%. Makoni stated that he expected to raise up to Zim $11.5 billion through this "enhanced customs revenue" in order to support the recently approved Zim $52 billion supplemental budget.

Economic Predictions

¶12. (C) At least one prominent local economist, who has excellent Zanu-PF connections, theorizes that the current GOZ position on devaluation will be maintained for the next few months. However, he anticipates a minimal devaluation by September/October to the 180:1 range. According to his calculations, the population has already suffered the major shock related to devaluation since many products have moved from the formal marketplace to the parallel market, which is providing goods at the 700:1 range. If the GOZ devalued the Zim dollar enough to reach a blend rate of about 300:1, the general cost of inputs would drop, and since there would be less incentive for sellers to use the parallel market, goods would again be found in the formal sector. Since most goods are already the subject of targeted (if unofficial) devaluations, only energy and fuel costs would be radically affected by a general devaluation. Even though the energy and fuel costs would rise under a general devaluation, their inflationary increase would be balanced by the deflationary effect on most other goods, and the net effect would not be inflationary.

Conclusion

¶13. (C) Comment: The GOZ has created a de facto patchwork devaluation based on its announcement of a "viability price" for tobacco, along with its implementation of the 300:1 valuation for luxury goods. As one local economist observed, when any president says "never" to devaluation, that is the moment to expect it imminently -- although in the case of Zimbabwe, through a stealth devaluation, or devaluation "through the back door," allowing the GOZ to preserve deniability and save face. In some circles, there is certainty that change must come within the next six months based on several factors. The first factor is growing hunger, which is demonstrably affecting more people and their families; and as one recent letter to the editor stated, "A hungry man is an angry man." The other factor is increasing divisions within the Zanu-PF politburo, where consensus is emerging on the need to take rational steps to address the economic debacle, although nobody -- aside from Makoni -- yet seems willing to move from words to action. End comment.
WHITEHEAD